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No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California for the Third Appellate District

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BRIEF FOR KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS) AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF THE AMICUS CURIAE

The Amicus is the Keidanren (Japan Federation of Economic Organizations), a private, non-profit organization representing all branches of economic activity in Japan and consisting of over 1000 members, 125 of which are trade associations and regional economic organizations, and the balance of which are leading Japanese corporations.[1] Many of the Japanese corporate members or their affiliates conduct business in the state of California either directly or through United States subsidiaries.[2] Many of these

[1] All parties to this action have consented to the filing of this brief. Copies of the written consents have been lodged with the Clerk of the Court.

[2] Such Japanese-owned multinational corporate groups are referred to herein as "Japan-based Multinational Groups" and are included in the parallel term "Foreign-based Multinational Groups," as the context requires.

Japan-based Multinational Groups were subject to California's worldwide combined formula apportionment method (hereinafter the "Unitary Method") during the year in issue.

The interest of the Amicus differs from the interest of the Petitioner because of the decisive effect on the issue at bar of two treaties between the United States and Japan. These treaties are not applicable to United Kingdom residents such as the Petitioner. The first treaty is the "Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income" (the "U.S.-Japan Tax Treaty").[3] The second treaty is the "Treaty of Friendship, Commerce and Navigation Between the United States of America and Japan (the "U.S.-Japan FCN Treaty").[4] Both of these treaties were signed prior to the time California began applying the Unitary Method with respect to Foreign-based Multinational Groups.[5]

Although the Amicus believes that the decision of the California Supreme Court is incorrect and should be reversed, the Amicus believes also that these two treaties between the United States and Japan distinguish the Amicus' situation from that of the Petitioner. If this Court finds that the Unitary Method does not violate the Foreign Commerce Clause with respect to United Kingdom resident corporations because Congress' reservation in respect of Article 9(4) of the U.S.-U.K. Tax Treaty[6] constituted

[3] 23 U.S.T. 967, T.A.I.S. No. 7365 (March 8, 1971).

[4] 4 U.S.T. 2065, T.I.A.S. No. 2863 (Apr. 2, 1953). Other nations have entered into Treaties of Friendship, Commerce and Navigation with the United States. These treaties are referred to herein as "FCN Treaties."

[5] *Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, No. 325059, Cal. Super. Ct. (Aug. 20, 1987) *reprinted in* Appendix A to Petitioner's Cert. Brief., at A-17.

[6] Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (herein "U.S.-U.K. Tax Treaty"), 31 U.S.T. 5668, T.A.I.S. No. 9682 (Dec. 31, 1975).

Congress' acquiescence in the Unitary Method as applied to United Kingdom corporations, this Court should reserve on the issue of whether the same result should apply in the case of Foreign-based Multinational Groups that are entitled to protection provided by a different United States tax treaty. Further, a decision against Petitioner in this case should not control the issue of the Unitary Method's validity in the case of Japan-based Multinational Groups entitled to the benefits of the U.S.-Japan FCN Treaty because there is no FCN Treaty between the United Kingdom and the United States and the U.S.-Japan FCN Treaty proscribes application of the Unitary Method.

ISSUES ADDRESSED BY THE AMICUS CURIAE

Whether the basis for the California Supreme Court's finding Congressional approval of the Unitary Method and upholding the constitutionality of the Unitary Method as applied to Foreign-based Multinational Groups was fatally flawed? If so, whether a correct analysis leads to the conclusion that the Unitary Method, as applied to Foreign-based Multinational Groups, is unconstitutional under the Foreign Commerce Clause, because the Unitary Method results in double taxation and prevents the Federal Government from speaking with "one voice when regulating commercial relations with foreign governments," as evidenced by recent foreign government retaliation against the United States in response to continued use of the Unitary Method? If not, whether the issue nevertheless should be reserved as to whether a different result is appropriate in the case of Japan-based Multinational Groups entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty?

INTRODUCTION AND SUMMARY OF ARGUMENT

Under the Unitary Method, Japanese and other foreign parent corporations are required to file a combined return with all of their worldwide subsidiaries (the "combined report"). A portion of the

total worldwide income of the combined group is then allocated to California under a "three-factor formula" apportionment method that is based on the proportion of property, payroll and sales in the taxing state compared to the same factors of the worldwide consolidated group.[7] Under California's Unitary Method, corporations that are more than fifty percent foreign-owned are included in the combined report without regard to whether they have (i) engaged in business in California or elsewhere in the United States, (ii) derived income from sources within California or elsewhere in the United States, or (iii) engaged in any transactions with a related corporation incorporated in California or elsewhere in the United States.[8]

The Unitary Method is fundamentally different from and irreconcilable with the arm's length standard and the separate entity accounting method (the "arm's length method"). The arm's length method is the international standard universally used and accepted by the nations of the world and by multinational corporations. It is the method required by United States tax treaties, FCN treaties and the Internal Revenue Code. The arm's length method treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container Corporation of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 185 (1983). In the international context, the arm's length method allocates income to a single taxing jurisdiction rather than arbitrarily apportioning the income among jurisdictions, and treats intercorporate transfers of value between commonly controlled entities in accordance with the terms that would have been obtained

[7] *See* CALIF. REV. & TAX CODE §§ 25128-25136 (West 1992).

[8] Under legislation enacted in 1986 (and effective in 1988), California provided corporations with a "water's edge" election to avoid application of worldwide formulary apportionment to income of their foreign affiliates and parents. *See* CAL. REV. & TAX CODE § 25110 (West 1992). California further limited the obligation to use the Unitary method in October 1993. Because the year in issue is prior to the legislative changes, we have not addressed whether these changes "cure" the constitutional defects of the Unitary Method.

had such transfers occurred between uncontrolled entities in similar circumstances.[9]

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), this Court found that if a state tax "is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," no impermissible burden on interstate commerce will be found. In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court identified two additional criteria under the Foreign Commerce Clause for testing the validity of a state tax affecting foreign commerce. A state tax will violate the Foreign Commerce Clause, notwithstanding its compliance with the four criteria in *Complete Auto Transit*, if it "creates a substantial risk of international multiple taxation" or "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"

In *Container*, this Court held that California's Unitary Method did not violate the Foreign Commerce Clause when applied to United States-owned domestic corporations with foreign subsidiaries ("U.S.-based Multinational Groups"). However, the *Container* opinion specifically reserved on the issue of whether California's Unitary Method violated the Foreign Commerce Clause as applied to Foreign-based Multinational Groups.[10]

In *Wardair Canada Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), this Court upheld Florida's aviation fuels tax as applied to Canadian air carriers engaged in international commerce. The carrier and the United States had conceded that no risk existed of multiple taxation so that only the "one voice"

[9] The power to enforce such treatment by allocating income among related parties and jurisdictions under the arm's length method is established by section 482 of the Internal Revenue Code, 26 U.S.C. § 482, and the Associated Enterprises article of United States tax treaties.

[10] *Container*, 463 U.S. at 189 n.26, 195 n.32.

test under *Japan Line* was applicable. The Court found it dispositive under this test that while a United States-Canada aviation treaty (and other similar treaties) were silent on limiting state taxation of aviation fuel, the Federal Aviation Act expressly permitted the states to tax such fuels.

In the case below, the California Supreme Court concluded that *Wardair* had "reoriented" dormant Foreign Commerce Clause analysis so as to make such analysis inappropriate in this case. Specifically, the California Supreme Court cited a number of "negative implications" that it believed were created by United States Senate or Congressional actions. The California Supreme Court relied on these alleged "negative implications" to support its conclusion that Congress had in effect affirmatively approved of the Unitary Method.[11] Among the actions from which the California Supreme Court extracted these "negative implications" were the Senate's reservation to Article 9(4) of the U.S.-U.K. Tax Treaty, the Senate's ratification of other United States tax and FCN treaties, and Congress' enactment of certain provisions of the Internal Revenue Code, particularly section 482.

The California Supreme Court's interpretation and analysis are incorrect. In fact, the Unitary Method, when applied to Foreign-based Multinational Groups such as the Petitioner herein, is completely irreconcilable with the relevant provisions of United States tax and FCN treaties, as well as the Internal Revenue Code.

In addition, the taxation of a Foreign-based Multinational Group's income demands that the Federal Government speak with "one voice" to foreign governments. The failure to find the Unitary Method violative of the Foreign Commerce Clause will result in our treaty partners hearing "many voices" on the issue of the appropriate taxation of Foreign-based Multinational Groups. All treaty jurisdictions must follow the internationally agreed norm of the arm's length method as embodied in tax treaties in order for multinational corporations to engage in international commerce and

[11] 829 P.2d 279, 295 (1992).

avoid multiple taxation of the same income. Further, while certain practical problems may exist with the application of the arm's length method, *only* the arm's length method makes possible a mechanism to prevent double taxation—the Competent Authority procedures contained in United States tax treaties.

If this Court finds California's Unitary Method constitutional when applied to United Kingdom-based Multinational Groups, this Court should nevertheless reserve on the issue of whether the same interpretation applies to Japan-based Multinational Groups entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty.

ARGUMENT

I. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON UNITED STATES TAX TREATIES AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

In upholding the Constitutionality of California's Unitary Method, the California Supreme Court cited two instances of Senate *inaction* in the tax treaty context which the court believed created decisive "negative implications." Based upon these "negative implications," the court concluded that Congress had affirmatively approved the Unitary Method. As the opinion stated, paraphrasing *Wardair*:

> [I]nternational agreements demonstrate that the Federal government has affirmatively acted, rather than remained silent, with respect to the power of the states to employ formula apportionment in so-called foreign parent cases.[12]

[12] 829 P.2d at 294.

According to the California Supreme Court's opinion, the "din of 'governmental silence' that cannot be ignored"[13] was evidenced by two treaty-related phenomena. First, the court found it decisive that United States tax treaties uniformly obligate the Federal Government to utilize the arm's length method, but uniformly *exclude* the state governments from all treaty obligations except those contained in the non-discrimination article. Second, the court found decisive the Senate's lodging of a reservation to Article 9(4) of the U.S.-U.K. Tax Treaty, which would have prohibited the states' use of the Unitary Method with respect to U.K.-based Multinational Groups.

Based in significant part on these "negative implications" the California Supreme Court ruled that the case at bar was not an appropriate case for dormant Foreign Commerce Clause analysis, because that analysis "'only operates where the Federal Government has not spoken.'"[14] According to the court, in this case, the Federal Government had indeed spoken and had approved the states' use of the Unitary Method.

The ensuing sections of this brief address why the California Supreme Court's analysis is wrong, why such analysis should not be applied in any event under earlier tax treaties (such as the U.S.-Japan Tax Treaty), and why the correct analysis leads inescapably to the conclusion that the arm's length method must prevail over the Unitary Method.

A. The California Supreme Court's Interpretation That Congressional Silence on State Taxation in United States Tax Treaties Negatively Implies Congress' Acquiescence in the Unitary Method Is Incorrect.

The California Supreme Court noted that the "bilateral income tax treaties negotiated by the United States with many of its trading partners typically prescribe use of the [arm's length] method by the

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[13] *Id.*

[14] 829 P.2d at 293 (*quoting Wardair*, 477 U.S. at 12).

signatory governments" but "they do not ... impose such a requirement on taxation by subnational levels of government."[15] Because subnational levels of government are included for purposes of the nondiscrimination article, the California Supreme Court concluded that:

> We think this latter evidence substantially parallels the *Wardair* paradigm, where the high court concluded that the "negative implications" arising from the Convention's limited ban on state taxation of fuel "on board" arriving foreign aircraft demonstrated an awareness of subnational taxation issues and represented "a decision by the parties ... to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority."[16]

The convention referred to was the Convention on International Civil Aviation.[17] This Court found that Article 24(a) of that convention "by its terms precluded the imposition of local taxes on fuel only when the fuel is 'on board an aircraft ... on arrival ... and retained on board on leaving' a contracting party."[18] In *Wardair* this Court found direct language contained in an international agreement that limited a state's power to tax. This Court found that the negative implication of this limitation was Congress' approval of state taxation that was not directly proscribed in the agreement.

In the case at bar, the California Supreme Court, citing the absence of any explicit tax treaty limit on the power of states to tax (except that the states not discriminate), found such Federal Government silence on state taxation to be evidence of the Federal

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[15] 829 P.2d at 298.

[16] *Id.*

[17] *open for signature* Dec. 7, 1944, art. 24(a), 61 Stat. 1180, 1186, 3 Bevans 944, 950.

[18] *Wardair*, 477 U.S. at 10.

Government's affirmative acquiescence in state use of the Unitary Method. Such an interpretation goes far beyond *Wardair's* "negative implications," and elevates silence on an issue to a new level of communication.

The conclusion of the California Supreme Court overlooks a far simpler explanation for the exemption of state taxes from the tax treaties: the general principle of state sovereignty. Both the Federal Government and the states have concurrent taxing powers.[19] The Federal Government is cognizant of the friction caused by the Federal Government's Foreign Commerce Clause power and state taxing sovereignty. In that regard, the Executive Branch has not seen fit to regulate states' taxation authority until the state tax laws cause international concerns.[20]

Further, respecting the states' sovereignty over taxation, while attempting to provide coverage for state taxation within the scope of United States tax treaties, is unworkable. The United States cannot negotiate a treaty with 50 additional participants at the table. Moreover, not covering state taxes in the treaties was never intended to give the states free and unfettered license to tax in a way that conflicts with federal taxation principles the same international parties and transactions as are covered by the treaties. Such an approach would effectively frustrate the very purpose of the tax treaty to harmonize national systems and prevent double taxation.

The California Supreme Court's reliance upon the exclusion of state taxes from United States tax treaties—a recognition of our federal system—as the Federal Government's affirmative approval

[19] *Hines v. Davidowitz*, 312 U.S. 52, 68 (1941); The Federalist No. 32 (Alexander Hamilton).

[20] Following California's adoption of the Unitary Method and this Court's decision in *Container*, the Executive Branch has repeatedly studied and proposed measures to restrict the application of the Unitary Method to Foreign-based Multinational Groups. *See generally Colgate-Palmolive Co., Inc. v. Franchise Tax Bd.*, 4 Cal. App. 4th 1681, 1701-8 (1991) *vacated and remanded*, 831 P.2d 798 (Cal. 1992).

of the Unitary Method cannot be supported. The Federal Government's silence on state taxation issues cannot overcome its loud voice in support of the arm's length method as expressed in and through the tax treaty network.

B. The Failure of Congress to Adopt the U.S.-U.K. Tax Treaty Without the Limitation on State Taxation Contained in Article 9(4) Cannot Be Interpreted as Congress' Acceptance of the Unitary Method.

As detailed in the opinions in the case below, Article 9(4) of the U.S.-U.K. Tax Treaty explicitly limited Federal and state taxation to the arm's length method. The Treaty, signed in 1975, was one of the first treaties negotiated after California enacted the Unitary Method.

When the Treaty was considered by the Senate Foreign Relations Committee, Senator Frank Church introduced a reservation to Article 9(4). The reservation provided "that the provisions of paragraph (4) of Article 9 ... shall not apply to any political subdivision or local authority of the United States."[21] When voted on in committee, the reservation was rejected 10 to 5. On the Senate floor, the reservation was again defeated by a vote of 44 to 34. The Treaty as signed then received a vote of 49 to 32, five votes short of the two-thirds needed. Thereafter, Article 9(4) was reserved without a vote and the treaty was ratified with the reservation. The reservation was effectuated by the Third Protocol to the U.S.-U.K. Tax Treaty.

The California Court of Appeals appropriately stated that it "fail[ed] to see how three majority votes in the Senate essentially approving article 9(4) could be transmogrified into a *congressional policy* of disapproval" of the treaty provision.[22] The Court of Appeals also noted that the opposition to the treaty-based

[21] 124 Cong. Rec. 18416 (1978).

[22] *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 3 Cal. App. 4th 1034, 1055 (1990).

restriction was not rooted in the substance of the article, but was instead reflected in certain Senators' opposition to dealing with this problem on a piecemeal basis instead of by comprehensive legislation.[23] Legislation that would restrict the states' ability to use the Unitary Method has been introduced in Congress,[24] but has never reached a vote in committee or on the floor.[25]

The California Supreme Court wrongly concluded that Congress' adoption of the U.S.-U.K. Tax Treaty with the reservation as to Article 9(4) reflected Congress' affirmative

[23] In fact, Senator Howard Baker stated:

> In adopting its reservations to Article 9(4) in June of 1978, the Senate appeared to reach a consensus that domestic legislation, as an alternative to international treaty language, is preferable in regulating that conduct of the States which may affect foreign commerce.
>
> * * *
>
> [T]he States may incorrectly interpret the Senate's reservation to Article 9(4), and the Third Protocol to this Convention, as an invitation to establish policies applicable to foreign source income which are inconsistent or incompatible with broad National tax policies.

Committee on Foreign Relations, Rep. on the Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Exec. Rep. No. 5, 96th Cong., 1st Sess. 15 (1979).

[24] It should also be noted that none of these bills dealt solely with restricting the states' ability to use the Unitary Method. Therefore, Congress' inaction could be the result of an entirely unrelated provision in those bills.

[25] *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 3 Cal. App. 4th at 1054. The California Supreme Court used this lack of action on these bills as further evidence of Congress' acquiescence in the Unitary Method. 829 P.2d at 296. If *inaction* on the part of Congress is correctly interpreted as *action* on the opposite point, then Congress' failure to vote on the Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess., which would have required a foreign-owned corporation engaged in substantial related party transactions to report a minimum formulary amount of taxable income, should be interpreted as evidence of Congress' affirmation that formulary methods that deviate from the arm's length standard are inappropriate. We are not necessarily advocating this position; we simply believe Congress' silence should be interpreted as that—silence.

approval of the Unitary Method, thereby removing this case from a dormant Foreign Commerce Clause analysis. A reservation is not an affirmative statement.

The California Supreme Court's interpretation is inconsistent with the intent of both Congress and the United Kingdom Government. Given the majority votes in favor of the original treaty provision, and the ~~various~~ reasons Senators may have voted for the treaty with the reservation, it is impossible to conclude as a factual matter that Congress intended to authorize the Unitary Method. Similarly, given the United Kingdom's outspoken opposition to the Unitary Method, it is impossible to interpret Congress' reservation as the *United Kingdom's* acceptance and approval of the Unitary Method.

The California Supreme Court's interpretation of the treaty reservation is completely at odds with this Court's standards for treaty interpretation: "Like other contracts, [treaties] are to be read in the light of the conditions and circumstances existing at the time they were entered into, with a view to effecting the objects and purposes *of the states* thereby contracting."[26] The only interpretation consistent with the intent of both parties is that the reservation nullified the provision.

If the California Supreme Court's interpretation of the reservation to Article 9(4) is approved by this Court, such approval will establish an entirely new standard for treaty interpretation. Such standard would allow the courts of the United States to interpret treaty provisions in a manner wholly inconsistent with the intent of the treaty partner. Therefore, such a standard

[26] *Rocca v. Thompson*, 223 U.S. 317, 331-32 (1912) (emphasis added). This rule of treaty construction has been adopted by many other courts. *See Maximov v. United States*, 299 F.2d 565, 568 (2d Cir.) (The objective is to "give the specific words of a treaty a meaning consistent with the genuine shared expectation of the contracting parties.") *aff'd*, 373 U.S. 49 (1963); *Johansson v. United States*, 336 F.2d 809, 813 (5th Cir. 1964); *Estate of Burghardt v. Commissioner*, 80 T.C. 705, 708 (1983); *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925, 933 (1971).

will attract widespread international protest, and could ultimately impair the ability of the Executive Branch to negotiate and conclude treaties.

C. Even If This Court Accepts the California Supreme Court's Interpretation of the Ratification of the U.S.-U.K. Tax Treaty with the Reservation to Article 9(4), Such Interpretation Should Have No Effect upon a Tax Treaty (Such as the U.S.-Japan Tax Treaty) Adopted Prior to California's Adoption of the Unitary Method.

Taxpayers entitled to the protections of treaties negotiated and signed *prior* to California's adoption of the Unitary Method, such as Japan-based Multinational Groups, should not be held to any "negative implication" of Congress' reservation with respect to Article 9(4) of the U.S.-U.K. Tax Treaty. Tax treaty negotiations are bilateral negotiations. The Japanese government and the United States Government negotiated their treaty *prior* to California's adoption of the Unitary Method. Japan had no reason to request a provision requiring the states to use an arm's length method when that was the method already generally employed by the states in taxing Japan-based Multinational Groups.

The Senate's reservation to Article 9(4) and the adoption of the Third Protocol to the U.S.-U.K. Tax Treaty by the United Kingdom Parliament should in no way be binding on treaties negotiated prior to California's adoption of the Unitary Method. If this Court should rule that the Senate's reservation with regard to Article 9(4) of the U.S.-U.K. Tax Treaty results in a negative implied approval of the Unitary Method, this Court should reserve on the issue of whether that reservation has a similar effect on corporations entitled to benefits under treaties that pre-date both the Senate's vote and California's adoption of the Unitary Method.

D. Uniformity in the Taxation of Foreign-based Multinational Groups Is Essential in Order for the Federal Government to Speak with One Voice Through the United States Tax Treaty Network and in Order to Prevent Double Taxation.

The California Supreme Court never addressed the *Japan Line* tests of Foreign Commerce Clause analysis (namely, the "one voice" and multiple taxation tests). The Amicus believes that the California Supreme Court's analysis is incorrect, and that this Court should apply the *Japan Line* "one voice" and double taxation tests.

With regard to the "one voice" test, the extraordinary consensus of nations regarding the arm's length method, as embodied not only in the United States tax treaty network but in the tax treaty networks of virtually all other countries (both developed and developing), attests to the importance of permitting the United States to speak with "one voice," rather than 50 or more voices. Thus, the California Superior Court found as a factual matter that:

> There is an international standard of accounting universally practiced by all nations of the world, including the United States, the AL/SA [Arm's Length/Separate Accounting] method. It is used to determine income of business entities derived from operations in countries other than their own, for purposes of income taxation by those countries. It operates on the assumption that only the income actually earned within a foreign country should be taxed by it (no double taxation), but because that cannot always be determined with exactitude, AL/SA uses formulary allocations when and as needed. But it is indisputable that its aim is to determine as closely as possible what actual income is derived from activities within the geographical boundaries of the taxing nation, and tax that income only.

As the above-quoted finding suggests, the country-by-country approach to determining "actual income" derived from and taxable by each country is a unique hallmark of the arm's length method which, in part because the method respects geographic boundaries (and national sovereignty), is the sole internationally accepted method.[27] The method is deeply ingrained in the prevailing OECD and U.N. Model Treaties which are the starting points for the negotiation of new or revised bilateral treaties. Such method is the main foundation of common ground upon which national tax systems (and in many instances subnational tax systems) are harmonized in and through tax treaties. It requires only the most summary view of how United States tax treaties determine tax jurisdiction under the separate country arm's length method to see how any material departure from this method, such as California's application of the Unitary Method to Foreign-based Multinational Groups, could disrupt treaty relationships and cause multiple taxation.

There are two bases on which the treaties permit taxation to be exercised—source and business presence. First, source-based taxation is predicated upon certain types of income derived from sources within the paying country being subject to a limited tax based on the gross amount of the payment. Some treaties exempt certain of these payments entirely from taxation by the source country. The purpose of the reduced or zero taxation is to foster the free flow of capital into the nation of the payor of the income.

Second, the United States may generally tax a corporation, resident in a treaty partner country that earns "business profits" in the United States if the corporation maintains a "permanent establishment" in the United States. In general, a permanent establishment is defined under most treaties as a fixed place of business through which the business of an enterprise is wholly or

[27] The arm's length method may be considered a "custom of nations." *See Colgate-Palmolive Co., Inc. v. Franchise Tax Bd.*, 4 Cal. App. 4th 1681, 1710 (1991) *vacated and remanded*, 831 P.2d 798 (Cal. 1992); American Law Institute, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES, 2-10 (1991).

partly carried on.[28] Under the permanent establishment articles, minor actions taken in the United States, *e.g.* auxiliary or preparatory activities, or merely holding the stock and overseeing United States subsidiary corporations, will not rise to the level of a permanent establishment,[29] *i.e.*, income from these activities will not be taxable. The "permanent establishment" standard, as agreed by the international community, is a more difficult nexus test than the "flow of value"[30] test required to include a foreign corporation in the Unitary Method's "combined report."

The treaties also provide mechanisms to ensure that the amount of net income reported in each treaty partner country in connection with inter-branch or inter-company transactions with the multinational group is properly determined under the arm's length method. Thus, the "business profits" articles of United States tax treaties contain an arm's length independent entity standard for determining the taxable income of a permanent establishment. Similarly, the Associated Enterprises articles of United States tax treaties allow either treaty partner to allocate profits from a corporation to a related corporation in the other country to the extent necessary to ensure that the transactions are on an arm's length basis. If related parties engage in non-arm's length transactions, the treaties do not necessarily prohibit the use of a formulary method to place the transaction on an arm's length basis. However, any allocation of income from a United States corporation to a related foreign corporation, regardless of the method utilized, is only permitted to the extent there are actual transactions between related parties and such transactions have been conducted on a non-arm's length basis.

[28] Organization for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, art. 5 (1992) (hereafter "OECD Model Treaty"). *See also* U.S.-U.K. Tax Treaty, Article 5; U.S.-Japan Tax Treaty, Article 9 ("a fixed place of business through which a resident of a Contracting State engages in industrial or commercial activity").

[29] *Ibid.*

[30] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 178 (1983).

While the specific rules implementing the foregoing concepts may differ somewhat from country to country, the concepts and the framework on which they operate are universally accepted. On the other hand, the Unitary Method is inconsistent with the foregoing internationally agreed norms of taxation contained in the treaties. The Unitary Method determines income attributable to California by including all of the worldwide income of the unitary group, without regard to the fact that a large portion of that income has its source *outside* California, and in fact *outside* the United States.

The Unitary Method includes all of the income of a Foreign-based Multinational Group into the "pool" of income from which California allocates a portion to the state, even if the foreign parent and affiliate have *no* United States source income, are *not* engaged in a trade or business in the United States through a permanent establishment, and do not engage in non-arm's length transactions with related parties in the United States. United States tax treaties uniformly concede tax jurisdiction in respect of this income to the foreign treaty partner jurisdiction. Unless the foreign jurisdiction has a zero percent tax rate, double taxation will result when California taxes this income.

The Unitary Method further violates the underlying principles of international taxation embodied in United States tax treaties by allocating the income of a foreign parent and its foreign subsidiaries to the parent's United States subsidiary. United States tax treaties do not allow the United States to tax the income of a foreign parent corporation merely because its subsidiary is engaged in business in the United States. Similarly, while the United States provides for certain deemed inclusions from subsidiaries to the parent,[31] a deemed inclusion from a parent to its subsidiary is without precedent where the parties are otherwise dealing with one another on an arm's length basis. Without a finding of non-arm's length transactions, the Unitary Method's combination of the income of a foreign parent (and its other foreign subsidiaries) with

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[31] *See* Subpart F, 26 U.S.C. §§ 951-964.

the income of a corporation engaged in business in the United States is without foundation or justification under the internationally accepted norms contained in tax treaties.

The fact that the Unitary Method is fundamentally inconsistent with the arm's length method embodied in the treaties has already attracted international protest and retaliation. Most significantly, if the Unitary Method were upheld, as applied to Foreign-based Multinational Groups, it would interfere with and disrupt the Federal Government's ability to negotiate and conclude future tax treaties. Accordingly, the Amicus submits that the need for federal uniformity in this area is compelling and that the Unitary Method should be held suspect under the "one voice" test.

Under the second *Japan Line* test relating to multiple taxation of the same income, the Unitary Method also must fail because it provides no method for eliminating such double taxation. Because the Unitary Method taxes a California corporation on an amount determined by a formula to be California taxable income without regard to whether such income is also being reported as the income of a foreign affiliate for foreign tax purposes, instances of double taxation almost certainly will occur. Double taxation will always occur where, under international normative rules as embodied in United States tax treaties, the income taxed by California is reserved for taxation by a treaty partner. The Unitary Method, however, provides no mechanism to relieve this double taxation.[32] On the other hand, the arm's length method does provide such a system to relieve international double taxation.

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[32] *Compare Itel Containers Int'l Corp. v. Huddleston*, 122 L. Ed. 2d 421, 436 (1993), where this Court recognized that Tennessee's provision of a credit for foreign or domestic taxes paid on the same transaction to which Tennessee was levying its tax, reduced, if not eliminated, the risk of international multiple taxation. It should be noted that California has no such foreign tax credit mechanism.

The Associated Enterprises or Mutual Agreement article of most United States tax treaties contains a provision similar to the following provision from the OECD Model Treaty:[33]

> Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned state if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

The competent authorities referred to are authorized by the Mutual Agreement articles of United States tax treaties to endeavor to resolve disputes between the two states relating to, among other things, the taxation of transactions between related parties and the prevention of double taxation.

The availability of the competent authority procedure, and of the correlative adjustment mechanism to ensure consistent treatment of intercompany transactions in both jurisdictions, substantially reduces the risk of double taxation. California has no mechanism available to a taxpayer subjected to double taxation caused by the Unitary Method.

This Court has noted that California, because it is *not* a party to United States tax treaties and is *not* authorized by the constitution to negotiate its own tax treaties, may not avail itself

[33] OECD Model Treaty, Article 9(2). *See also* U.S.-Japan Tax Treaty, Article 25(2); U.S.-U.K. Tax Treaty, Article 9(3).

directly of this competent authority process.[34] However, California may receive information from the United States regarding competent authority negotiations and adjustments made to a taxpayer's transfer prices as a result of competent authority negotiations.[35] If California required taxpayers to use the same intercompany prices as reflected on their federal returns, and to amend those returns if any adjustment was made (either by the IRS or the competent authorities), California could effectively eliminate the risk of double taxation.

The competent authority process has proven effective. In addition, there are procedures either in place or pending with many of our treaty partners to enter into bilateral "advance pricing agreements" relating to particular taxpayers, whereby the competent authorities agree on a correct intercompany pricing methodology on a prospective basis. This procedure, also only available under treaties, may further reduce the incidence of double taxation.

Because no mechanism whatever exists to prevent or relieve the multiple taxation resulting from application of the Unitary Method to Foreign-based Multinational Groups, the Unitary Method fails the second *Japan Line* test by creating a substantial risk of multiple taxation.

II. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON PROVISIONS OF THE INTERNAL REVENUE CODE AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

The notion that section 482 of the Internal Revenue Code supports the Unitary Method is preposterous. Yet, the California

[34] *Container*, 463 U.S. at 192 n.31.

[35] 26 U.S.C. § 6103(d) provides that returns and return information shall be open for inspection by, or disclosure to "any State agency, body or commission, or its legal representative, which is charged under the laws of such State with responsibility for the administration of State tax laws...."

Supreme Court's opinion cites the term "apportion" in section 482 as evidence that Congress in effect has long sanctioned state application of the Unitary Method. According to the opinion:

> [I]n enacting the Internal Revenue Code of 1956, Congress authorized the Secretary of the Treasury to "distribute, *apportion*, or allocate gross income ... between or among" multi-corporate enterprises, including those with foreign domiciles, "in order ... clearly to reflect [their] income" (26 U.S.C. § 482, italics added), a formulation that reflects at least an awareness of apportionment methodologies.[36]

The implication of the above-quoted passage is that Congress had knowledge of "apportionment methodologies" similar in concept to the Unitary Method and, far from prohibiting or limiting their use, actually endorsed their use to allocate income under section 482.

The proposition that the term "apportion" in section 482 had anything to do with a formulary, non-separate accounting concept similar to the Unitary Method is clearly wrong. The California Supreme Court's error is based on a misunderstanding of the legislative history of section 482. That history demonstrates Congress' overriding objective to prevent abuses involving the use of intercompany transactions to avoid tax by placing income improperly in a tax-favored entity and/or a tax-favored country. Congress authorized the IRS to correct such misallocations of income by reallocating the income back to the entity or country where it properly belonged. Only the arm's length method contemplates and provides for such entity-by-entity and country-by-country allocation. Because the Unitary Method is totally indifferent to whether income properly "belongs in" or is properly earned by or within any particular entity or country, Congress could not possibly have had a Unitary Method in mind when it

[36] 829 P.2d at 297.

originally enacted the predecessor of section 482. A brief review of the legislative history confirms this Congressional focus.

The antecedent of section 482 was contained in regulations promulgated under the authority of the Revenue Act of 1917 which required affiliated corporations to provide sufficient information about intercorporate relationships that would allow the Commissioner "to compute the amount of the tax properly due from *each* corporation on the basis of an equitable and lawful accounting."[37] In addition, the regulations generally authorized the Commissioner to allocate income and deductions among affiliated corporations and also to consolidate the accounts of such affiliated corporations "whenever necessary to more equitably determine the invested capital or taxable income...."[38] This authority to "consolidate accounts" was continued in section 240 of the Revenue Act of 1918.[39] The Senate Committee on Finance Report explained that such "consolidation ... prevent[s] evasion which cannot be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income ... to Company A [and] not enough to Company B."[40]

Section 240(d) of the Revenue Act of 1921 similarly authorized the Commissioner to "consolidate the accounts of ... related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."[41] The House Ways and Means Committee clarified that the provision's purpose was to prevent

[37] Reg. 41, art. 77, T.D. 2694 (1918) (emphasis added).

[38] Reg. 41, art. 78, T.D. 2694 (1918). *See Union Pac. R.R. v. Commissioner*, 17 B.T.A. 793 (1929), *acq.*

[39] ch. 18, § 240, 40 Stat. 1057.

[40] S. Rep. No. 617, 65th Cong., 3d Sess. 8-9 (1918).

[41] ch. 136, § 240(d), 42 Stat. 227.

arbitrary profit-shifting and other abuses, such as the use of a foreign subsidiary to "milk" the parent corporation "or otherwise improperly manipulate the financial accounts of the parent company," *not to compute tax on the basis of a consolidated return.*[42] That is, section 240(d) was not intended to allow the Commissioner to combine and apportion the incomes of related parties as if a consolidated return had been filed.

The provision first assumed substantially its modern appearance when reenacted as section 45 of the Revenue Act of 1928.[43] Section 45 specifically predicated the Commissioner's authority to reallocate income or deductions upon the objective to prevent tax avoidance and ensure the clear reflection of the income of the related parties (to determine their "true tax liability" in the words of the House Ways and Means Report).[44] Neither in the 1928 Act nor in any predecessor legislation was the Commissioner given the authority to combine and apportion the otherwise separate net incomes of related taxpayers.

The proposition that section 482 and its predecessors could not be used by the Internal Revenue Service to combine and apportion the income of two or more related taxpayers or otherwise place them in effect on a consolidated return basis is made abundantly clear by the case law. Construing the scope of section 45 of the 1928 Act in this connection, the Tax Court in *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215, 1231-32 (1945), rejected the Commissioner's attempt to combine the incomes of a partnership and a corporation owned by the same interests, stating:

> The statute authorizes the Commissioner to "distribute, apportion, or allocate ... between or among such organizations, trade or business," but it does not specifically authorize him "to combine." Certainly, the

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[42] H.R. Rep. No. 350, 67th Cong., 1st Sess. 14 (1921) (emphasis added).

[43] ch. 852, § 45, 45 Stat. 806.

[44] H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

> Commissioner's own regulations, section 19.45-1, Regulations 103, negative the use of section 45 for the purpose of combining or consolidating the separate net incomes of two or more organizations, trades or business, as it states:
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> > * * * It [sec. 45] is not intended (except in the case of computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.
>
> It is apparent that the Commissioner's action here has produced "a result equivalent to the computation of consolidated income."

As the foregoing makes clear, the suggestion in the California Supreme Court opinion that section 482 contains explicit Congressional authorization to utilize a Unitary Method of taxation which consolidates the income of the combined enterprise is totally erroneous.

In fact, other provisions of the Internal Revenue Code also demonstrate Congress' conscious and consistent adherence to the arm's length method, particularly in the international context. As regards United States taxation of foreign parent-owned foreign corporations, the Code provides for tax jurisdiction in respect of these corporations only on their U.S. source income or income effectively connected with a United States trade or business.[45] While the Code authorizes the filing of consolidated returns, which "combine" the income of a number of separate corporations, foreign corporations generally may not be included in such a consolidated return.[46] In fact, this Court has held as a general rule that except in instances where the corporate form is a "sham or unreal" the separate existence of corporations and their

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[45] 26 U.S.C. §§ 881-882.

[46] 26 U.S.C. §§ 1501, 1504(b)(3).

shareholders must be respected.[47] In short, there is no basis for the California Supreme Court's suggestion that section 482 supports or authorizes the use of the Unitary Method or indeed any method other than the arm's length method.

III. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON UNITED STATES TREATIES OF FRIENDSHIP, COMMERCE AND NAVIGATION AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

Another factor relied upon by the California Supreme Court for the proposition that Congress has evidenced its "approval" of California's Unitary Method was Congress' ratification of a number of United States Treaties of Friendship, Commerce and Navigation. The California Supreme Court noted that these treaties, dating from the late 1940's, incorporated provisions that "preserve the states' freedom to employ methods that produced a tax 'reasonably allocable or apportionable' to the taxing jurisdiction...."[48] The California Supreme Court cited in particular an annotated draft of a FCN Treaty with Portugal. It should be clarified that the U.S.-Portugal FCN Treaty has never entered into force. Unlike the draft U.S.-Portugal FCN Treaty, the U.S.-Japan FCN Treaty did enter into force and thus is an appropriate subject of analysis.

If the California Supreme Court, rather than relying on the uneffectuated draft treaty with Portugal, had examined the U.S.-Japan FCN Treaty, coupled with a later FCN Treaty negotiated with France, the court would have been unable to conclude that the U.S.-Japan FCN Treaty supports the Unitary Method. In fact, the U.S.-Japan FCN Treaty requires the states to utilize the arm's length method with respect to the taxation of Japanese corporations.

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[47] *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943).

[48] 829 P.2d at 297.

FCN Treaties generally provide restrictions on the taxation of corporations resident in the other country.[49] The U.S.–Japan FCN Treaty provides that:

> In the case of companies of either Party engaged in trade or other gainful pursuit within the territories of the other party ... such other Party shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to its territories, nor grant deductions and exemptions less than those reasonably allocable or apportionable to its territories.[50]

Although the California Supreme Court found that similar language in the draft U.S.-Portugal FCN Treaty was consistent with a finding that Congress approved of the Unitary Method, this interpretation is in error.

The U.S.-Japan FCN Treaty was negotiated in the 1950's prior to the widespread adoption of the Unitary Method, and as this Court has held, a treaty must "be read in light of the conditions and circumstances existing at the time they were entered into...."[51] Because the arm's length method was, and is, the only internationally accepted method, the reasonably allocable or apportionable amount must be determined on the basis of the arm's length method. This conclusion becomes inescapable in view of the effect of the taxation provision in the later ratified U.S.-France FCN treaty.

Article XI(3) of the U.S.-Japan FCN Treaty provides that Japanese corporations shall not be subject to taxes more burdensome than those borne by companies of any *third* country. This "most favored nation" clause in effect restricts subnational

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[49] *Sumitomo Shoji Am., Inc. v. Avagliano*, 457 U.S. 176 (1982).

[50] U.S.-Japan FCN Treaty, Article XI(4).

[51] *Rocca v. Thompson*, 223 U.S. 317, 331-32 (1912).

(*e.g.*, state) taxation of Japanese corporations as a result of the taxation provisions of other international agreements to which the United States is a party, including the Convention of Establishment Between the United States of America and France.[52] Article 9(4) of this Convention provides that:

> [French corporations] shall not be subject, within the territories of the [United States], to any form of taxation upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are there engaged, the transactions which they accomplish there, or any other basis of taxation directly related to their activities within those territories.

By reason of the "most favored nation" clause in the U.S.-Japan FCN Treaty, this Article in the Convention with France imposes the obligation to utilize the arm's length method, including at the state level,[53] in determining the tax liability of Japanese corporations. The Article is entirely consistent with the arm's length method as reflected in United States tax treaties and the Internal Revenue Code. It provides for source taxation, taxation of business profits derived from an active trade or business, and transaction based taxation. Failure to require the application of the arm's length method demanded by this provision, when applied to a Japanese company, will violate the U.S.-Japan FCN Treaty.

The California Supreme Court never considered the effect of this later treaty with France, and therefore misinterpreted the "negative implication" of Congress' ratification of FCN Treaties. The existence of FCN Treaties not only fails to support the

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[52] 11 U.S.T. 2398, T.I.A.S. No. 4625 (Nov. 25, 1959).

[53] *Hines v. Davidowitz*, 312 U.S. at 64-65 ("This country ... has entered into numerous treaties of amity and commerce since its inception—treaties entered into under express constitutional authority, and binding upon the states as well as the nation.").

California Supreme Court's conclusion; it directly supports the opposite conclusion.

The United Kingdom and the United States are not parties to an FCN Treaty. Therefore, if this Court concludes that the Unitary Method as applied to the Petitioner is constitutional, this Court should reserve on the issue of whether the Unitary Method is nevertheless invalid when applied to a Japanese company protected by the U.S.-Japan FCN Treaty.

CONCLUSION

The California Supreme Court incorrectly upheld the Unitary Method on the basis of "negative implications." It decided Federal Government *silence* is actually Federal Government *speech*. It declared Federal Government *inaction* to be Federal Government *action*. This analysis is wrong and dangerous, and must be rejected. Absent such "negative implications," the application of this Court's "one voice" and multiple taxation tests demonstrates that the Unitary Method violates both of these tests, while the arm's length method does not. If, however, this Court determines that the Unitary Method as applied to U.K.-based Multinational Groups is constitutional, this Court should reserve on the issue of whether the same conclusion may be reached when applied to a

Japan-based Multinational Group entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty.

Respectfully submitted.

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